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Economic Report

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Commentary on Pertinent Economic Issues

Next: Victory At Home

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The speed and manner in which the American forces and their coalition allies won the Persian Gulf War has produced a significant change in the mood of individuals and businessmen all around the United States. The difference is palpable. It is reflected in the joyous homecoming celebrations, the parades, and in the ubiquitous American flags and yellow ribbons tied around trees, automobile antennas—and even lighthouses. These express feelings Americans have about themselves and their country that haven't been seen since the end of the Second World War.

If the past is any guide, these high spirits should soon translate into higher rates of spending. For example, in 1946, the first full year following the end of World War II, spending by consumers rose over ten percent in real terms, paced by a 66 percent jump in durable goods, as the lifting of wartime controls enabled Detroit to begin producing and selling cars once again. Business responded with a 16 percent increase in outlays for equipment, and a near-doubling in spending for structures. Exports shot up, too. The net result was a hefty 32 percent increase in private real gross national product.

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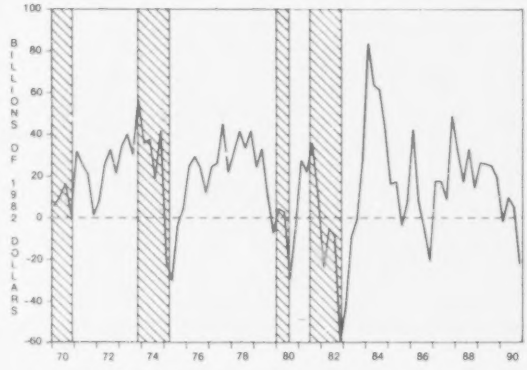
The end of the Korean and Vietnam Wars also led to greater private-sector spending—although not on the scale which came after World War II. This is because wartime needs in these two cases did not constrain the private economy the way they did in the 1940s, when controls were clamped on both spending and output. And while the direct effect of the Persian Gulf War on output and spending was virtually non-existent (except, of course, for those who were sent over to fight) because the military hardware had already been produced and stockpiled, its ending, by removing a cloud of uncertainty and lifting people's collective spirits, should nonetheless put consumers and businessmen in a spending frame of mind.

You can see it in the various surveys of the public's mood. The Conference Board says that in February—even while the war was still ongoing—confidence rose by the most for any month in three years. Early reports for March suggest an even bigger jump took place, following the war's end. The business mood has brightened, too. A new survey by Dun & Bradstreet shows that its Industrial Sentiment Index increased sharply in February compared with January, with expectations for the months immediately ahead at their highest since last summer.

The Recession Is Winding Down

Does this mean that America's ninth postwar recession is now over? Not quite. The war did not by itself cause the U.S. economy to turn down; other factors played a part—and they are still present. There is no doubt, however, that the invasion of Kuwait by Iraq last August did exacerbate the downward tendencies that were very much in evidence last summer (Economic Report—August 1990), so the end of the Persian Gulf crisis should provide at least some lift. When added to a number of other positive developments, it should lead to an end to this recession within a few months.

CHART I
REAL CHANGE IN BUSINESS INVENTORIES



Source: Commerce Department

One key reason for expecting economic activity to pick up soon is the state of business inventories. Usually they continue to rise after a recession has begun, as producers learn too late that sales have turned down. By the time production levels are trimmed below the pace of shipments, many months have gone by. This time, business stepped on the brakes quickly—so quickly, in fact, that inventories fell in 1990's fourth quarter, even though sales were still rising (Chart I). And shelves were half empty to

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begin with, thanks to widespread caution, use of computers, and "just-in-time" methods of inventory control.

While this haste to slash stockpiles depressed output quickly, it could lead to an equally as rapid upturn. This is because production must be raised to the level of sales, once desired inventory levels are reached—and if sales should be rising, however slightly, the rise in output schedules would have to be even faster. Of course, this would lead to greater demand for materials, supplies and labor, boosting sales, profits and incomes in the process.

This income growth, coupled with the sharp drop in prices of gasoline and heating oil back to the levels that prevailed last summer, before the invasion, will help translate these gains in consumer confidence into increased spending. And let's not forget the returning troops, many of whom are reservists who remained on their employers' payrolls while they were overseas—earning combat pay, exempt from taxes. They've got the confidence, the buying power—and the pent-up needs to add a lot to the spending totals.

Another plus stems from the value of the dollar. Although it has increased from its recent lows, it is still generally regarded as undervalued against the currencies of Western Europe. This alone has boosted exports, leading to our first trade surplus with these nations since 1982. The rebuilding of Kuwait will add further to exports, especially of construction, machinery and equipment, autos, communication facilities, etc.

Domestically, the war has already affected defense spending. Instead of declining as it was programmed to do, following the relaxation of tensions between the U.S. and the U.S.S.R., defense spending has kept rising. This uptrend is likely to continue for a while—if only because the war has reminded policymakers of the need to maintain a strong defense. This means a number of things, from keeping military pay scales high enough to attract people to the volunteer armed forces, to more research and development to ensure that our planes and missiles continue to have the technological edge that was crucial to winning Desert Storm.

In looking ahead, it is always useful to look back—in this case, to the behavior of the financial markets. Both stocks and bonds have rallied in recent months, adding significantly to household wealth. Bond prices were ten percent higher at the middle of last month than they were last August, as interest rates on the bellwether 30-year Treasury bond fell from 9.10 percent to 8.25 percent. For their part, stock prices have jumped by over 25 percent since early October—18 percentage points of which have come since the middle of January. This kind of rise in stock prices has never failed to signal the onset of an economic recovery within a few months.

Some Hopeful Signs

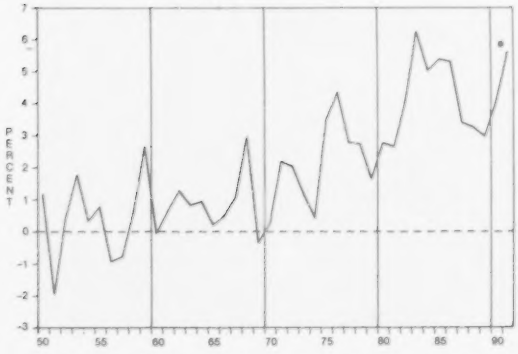
To be sure, there are a number of signs which already point to a winding down of the ongoing recession. These are faint, and could easily be reversed, should some unexpected development occur. But there are enough of them so that taken together, they point to an earlier—rather than a later—end to the recession:

- Industrial raw materials futures prices stopped falling in January, and have since moved five percent higher;
- The Purchasing Managers' Index of Industrial activity rose in February—the first monthly increase since last May;
- Manhours worked rose in February, as did payroll incomes;
- February saw a three percent jump in department store sales, after a rise of 0.6 percent in January, while new car sales have stabilized, so far this year;
- Fixed-rate mortgages, at 9¼ percent, are now at a four-year low. Combined with a drop in housing prices, it means that the average family is closer to affording a home than at anytime in the past decade;
- The money supply has begun to rise, reflecting increased lending activity by the banking system, on the heels of an easing by the Federal Reserve.

Although it was too tight for too long, there is no denying that the Fed moved to counter the decline in economic activity, once its magnitude became clear. In recent months, it added re-

serves to the banking system, dropping certain reserve requirements, while allowing the key Federal funds rate to fall 2½ points. In addition, it has cautioned bank examiners against overzealousness in pursuit of their tasks, while urging the banks to shed their reluctance to lend. And while nonborrowed reserves have risen sharply since the end of October, the Fed has recently begun encouraging the banks to borrow from its discount window to ensure the ready availability of loanable funds.

CHART II
REPORTED* FEDERAL BUDGET DEFICIT
AS A PERCENT OF GNP



e=OMB estimates includes S & L Bailout *Net of Trust Fund purchases
Sources: Treasury Department; Commerce Department; MH

Those who feel that these easing moves by the Fed are insufficient to jump-start the economy in the absence of assistance from fiscal policy would do well to remember three things: (1) Washington's budget deficit *is* growing; in the current fiscal year the gap will probably exceed $300 billion, up from $220 billion in FY 1990; (2) Even if it were the same as last year's, it would represent around four percent of GNP—one of the highest shares since the end of World War II (Chart II); (3) As we saw in 1982, once the Fed loosens up and makes enough money available, budget deficits become stimulative, for Washington can borrow without crowding out the private sector.

Maintaining Growth May Be Tough

With all three levers that control economic activity—monetary and fiscal policy and the value of the dollar in foreign exchange markets—now in the wide open position, not to mention the end of the war and the rise in the stock and bond markets, it is not too difficult to envision this recession ending within a few months. However, just like keeping the peace in the Middle East may well prove to be tougher than winning the war, so maintaining the economic recovery that is expected to get underway later this year might turn out to be harder than extricating the economy from recession. This is because, as noted earlier, many of the factors that gave rise to this recession are still very much around. They include:

- *The Tax Reform Act of 1986*, which, by changing the rules of investing, depressed real estate values and contributed to the weakening of the banking industry;
- *The higher capital gains tax*, which has also turned out to be a disincentive for investment;
- *Consumer tax burdens*, which have been increased by the elimination of the deductions for sales taxes as well as for interest expense on most types of loans—not to mention through sharp jumps in Social Security taxes, along with those on alcohol, tobacco, gasoline, and "luxuries."
- *Tightened regulatory standards* regarding bank capital ratios and the loan examination process, which continue to inhibit bank lending;
- *Debt loads* which remain high for both business and consumers;
- *Overbuilding* of commercial and residential buildings, which effectively precludes the increase in construction activity that usually helps boost the economy out of recession.

If these were not enough, there is the upward pressure on longer-term interest rates that may already be underway because of sizable governmental borrowing needs. Besides Washington, the governments of Kuwait, Saudi Arabia, Germany and Japan will be—or already are—tapping the markets for funds. At some point this could discourage long-term borrowing by the private sector, and could even put the kibosh on rising equities' prices. In this environment, one has to hope that the Fed will not reverse course, and tighten up at the first sign of economic growth, thinking it means renewed inflation. ■

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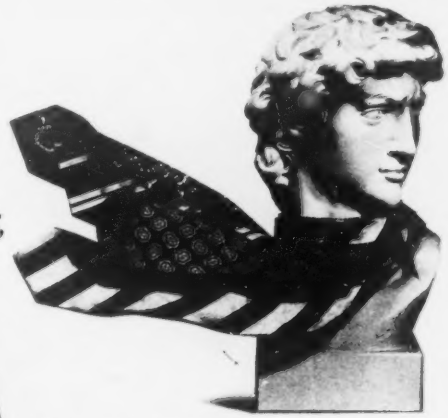

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